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¶1. (SBU) Summary: The consensus in German banking circles and the ECB is that the G-20 Summit in Pittsburgh set the stage for financial reforms and a new architecture that together will help reduce the dangers of another meltdown. In recent meetings with Economic Minister Counselor Robert Pollard and Consulate representatives in Frankfurt, top bankers, including the Vice President of the European Central Bank and the President of the Federal Financial Supervisory Authority (BaFin), expressed satisfaction with the results of the G-20 Summit, including the enhanced responsibilities of the Financial Stability Board (FSB). German bankers remain committed to the Basel II accords, but seek transatlantic agreement on what constitutes core capital and favor tighter regulation of rating agencies. Most believe it is too early to implement exit strategies from fiscal measures intended to counteract the economic crisis. End Summary.

The New Financial Oversight Architecture

¶2. (U) All of our interlocutors uniformly saw the "successful" Pittsburgh G-20 meeting as proof that governments are now more willing to cooperate on financial issues. It was a real "turning point" according to Thomas Mayor, Chair of the Management Board, JP Morgan Germany. Many parties also remarked that the quality of the G-20 discussion has improved with more members in it, including India and China although a few, such as Karlheinz Walch, Head of the Banking Sector Analysis Division at the Bundesbank, wondered if the wider forum will make it harder to reach consensus. Professor Andreas Noelke from Goethe University thought that the non-G7 countries will benefit because they will be able to enhance their negotiating positions through coalitions while others thought the G7 countries would still wield disproportionate influence in guiding financial reform.

¶3. (SBU) Members of the European Central Bank (ECB) in particular hailed the enhanced role of the recreated Financial Stability Board (FSB, formerly the Financial Stability Forum.) According to Lucas Papademos, Vice President of the ECB, the FSB's mandate is to prevent another financial crisis by coordinating between nations and reporting its findings to G-20 countries. Yet Papademos did note that in its new form, the FSB has more than 60 members, including institutions such as the Basel Committee and the IMF. This has tripled the number of committee meetings that Papademos himself must attend, he noted, while multiplying the number of individual

agendas. Mauro Grande, Director of Financial Stability and Supervision at the ECB, also observed that "there is a bit of tension about who does what." Grande feels however that the FSB committees still play a crucial role in macroprudential supervision by implementing common standards. So far, he said, Chairman Mario Draghi is doing a good job.

Core Capital

¶4. (SBU) Stronger core capital for banks is viewed among contacts as essential for financial stability. But German bankers remain concerned about differing international standards on what constitutes "Tier 1" core capital. BaFin President Sanio and Stephen Kohns from the Bundesbank both asserted that "silent partnerships" that are widespread in German banking, i.e. equity capital from investors who do not take part in management, is Tier 1 capital. The US has not always agreed. Sanio said that "we feel badly treated by the US" on this issue and criticized what he called an attempt to create an "uneven playing field to the disadvantage of continental banks." For Sanio, silent partnerships fulfill the same function as common stock (without the voting rights) and meet the three key criteria for core capital (participation in the business losses, being honored last in insolvency cases, and longevity.)

¶6. (SBU) While core capital is necessary, Karlheinz Walch from the Bundesbank warned that regulations that set capital percentages too high could affect the availability of credit in the German market. Walch said that German banks currently tend to keep their capital ratio around 4 percent points higher than the legal limit (at around 8-9 percent instead of the legally required 4 percent.) If the legal requirement moves up to 8-10 percent, Walch fears that banks may shift their benchmark to a level so high that it will dry up the credit market and sharply reduce bank profitability. Dr. Ralph Solveen, Senior Vice President of Commerzbank's Economic Research,

posited that the federal German government would not let such a credit crunch take place.

Leverage Ratios and Basel II

¶7. (SBU) Everyone we met was confident the EU will stick with Basel II. Mauro Grande from the ECB affirmed that the EU will implement Basel II regulations by 2011, including Basel II's risk sensitive requirements. Both he and Walch and Kohns from the Bundesbank did think, however, that some Basel II elements (treatment of the trading book, the calibration of credit risks, and the need for anticyclical buffers) should be revised. Sanio of BaFin urged the US to stick to its implicit commitment to Basel II (as evident in the "Framework for Strong, Sustainable, and Balanced Growth.") He added that if the US does not meet this commitment, its credibility in international negotiations will be undermined.

¶8. (SBU) The consensus for the high core capital standards in Basel II was complemented by consensus against the introduction of a leverage ratio (Tier 1 capital divided by average total consolidated assets) as a further measurement tool in regulation. Not only is it inconsistent with Basel II, Guenther Gebhardt, Professor of Accounting at Goethe University, pointed out, but there is, according to Bernhard Speyer, Head of Banking Research at Deutsche Bank, "no empirical evidence of a correlation between a bank failure and a bank's leverage ratio." President Sanio of Bafin, in fact, considers it "totally insane" to first create Basel II with risk-weighted capital requirements and then put a risk-indifferent measure like the leverage ratio on top of it. To him this is combining "stone-age with modern financial regulation." Another, more neutral observer pointed out that it is difficult to evaluate Basel II because it was just coming into effect when the global crisis hit, and Basel II should be given a chance to work before fiddling with it.

Rating Agencies and Insurance Supervision

¶9. (U) The quality of core capital would improve with better rating agency supervision, Mauro Grande of the ECB and Joachim Sanio of BaFin predicted, since the erroneous high ratings of "dirty core capital" greatly contributed to the crisis. An April 2009 EU Commission proposal empowers the European Securities and Markets Authority (ESMA) to regulate rating agencies starting in 2010, Grande noted. The ESMA will examine whether registered agencies (and they must now register in each EU country where they operate) comply with the International Organization of Security Commissions (IOSCO) Code of Conduct.

¶10. (SBU) President Sanio also argued that U.S. federal agencies need to monitor insurance companies (currently regulated at the state level), which would have helped in the crisis. The lack of a federal insurance regulator forces BaFin to sign numerous Memorandums of Understanding (MoUs) with state insurance regulators that have proven incapable of supervising global firms like AIG. When BaFin examined the US subsidiary Allianz Life of the German insurer Allianz, they found the U.S. regulator (based in the Midwest) to be very "locally oriented." Sanio thought that limited know-how of this nature poses a "global systemic risk."

Exit Strategies

¶11. (U) Central bankers think it is still too early to implement an exit strategy from recent financial rescue programs. The timing of exit strategies is also tricky, ECB Vice-President Papademos pointed out, as even the IMF is uncertain whether greater risk comes with exiting too early or too late. Dealing with adjustments in monetary policy is particularly difficult, according to both Papademos and Walch from the Bundesbank, since transmission mechanisms are longer than in the past, around 1.5 years. In other words, central bankers must anticipate what will be happening 1-2 years from now since their adjustments take that much time to reach the real economy. Walch was concerned that government policy in the U.S. might interfere with appropriate monetary adjustment. If the Fed, for example, waited to adjust monetary policy until unemployment rates went down, this would likely come too late to dampen demand.

¶12. (SBU) For his part, Papademos expressed confidence in U.S.

officials, praising the very good coordination between the Fed and the ECB in response to the financial crisis, particularly the Lehman Brothers collapse. He said, however, that the ECB and Fed do not necessarily need to coordinate on future interest rate changes. "There will be an information exchange and informal consultations, but no formal cooperation." Papademos expects that interest rate increases by the ECB and the Fed will not take place at the same time because the US is likely to come out of the recession earlier than the EU.

¶13. (U) This cable has been coordinated with Embassy Berlin.

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